Sheryl (Sherry) L. Herauf
Director
Federal Regulatory Relations

1275 Pennsylvania Avenue, N.W., Suite 400
Washington, D.C. 20004
(202) 383-6424

PACIFIC TELESIS
Group-Washington

August 26, 1996

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

DOCKET FILE COPY ORIGINAL

Dear Mr. Caton:

Re: *CC Docket No. 96-150, Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*

On behalf of Pacific Telesis Group, please find enclosed an original and six copies of its *"Comments"* in the above proceeding. A copy of the comments on diskette has been forwarded to Ernestine Creech in the Common Carrier Bureau's Accounting and Audits Division.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Sheryl L. Herauf (JB)

Enclosures

cc: Ernestine Creech (w/Diskette)

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Implementation of the Telecommunications Act of 1996:

Accounting Safeguards Under the Telecommunications Act of 1996

CC Docket No. 96-150

COMMENTS OF PACIFIC TELESIS GROUP

MARLIN D. ARD
LUCILLE M. MATES

140 New Montgomery Street, Rm. 1526
San Francisco, California 94105

(415) 542-7654

MARGARET E. GARBER

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

(202) 383-6472

Attorneys for PACIFIC TELESIS GROUP

Date: August 26, 1996

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SUMMARY

The Commission is correct to rely on its existing Part 64 and Part 32 rules to implement the accounting safeguards provisions of Sections 260 and 271 through 276 of the 1996 Telecommunications Act. As the Commission acknowledges, the rules adopted pursuant to Computer Inquiry III ("accounting safeguards") effectively prevent cross subsidy between regulated activities and nonregulated activities.

The Commission also acknowledges that price cap regulation, adopted after Computer Inquiry III, ensures that rates are just and reasonable and that cross subsidy does not occur. Price cap regulation (without a sharing mechanism) severs the link between costs and rates. Price cap carriers that elect the no sharing option have neither incentive nor ability to affect regulated rates by cross subsidizing. Thus, the Commission should forbear from applying the accounting safeguards to price cap carriers that elect the no sharing option.

Where safeguards are still required, however, Part 64 cost allocation rules will effectively protect against cross subsidy of integrated operations permitted by the 1996 Act. The rules requiring fully distributed costing were specifically intended to apply to a LEC's integrated nonregulated operations and should be no less effective for integrated operations permitted by the 1996 Act.

Incidental InterLATA services can also be accommodated under current rules. The Commission need not adopt its proposed alternatives. Cost of regulated incidental interLATA services will be separated from regulated local exchange and exchange access services by the current rules and driven to the interexchange price cap basket by the Part 69

process. Cross subsidy will also be prevented because the costs in one basket cannot affect the costs in any other basket.

Current Part 64 and Part 32 rules ("affiliate transaction rules") are also effective to protect against cross subsidy by the BOC when activities are provided by an affiliate required by the 1996 Act. The affiliate transaction rules specifically guard against cross subsidy in transactions between a LEC and any of its affiliates.

For manufacturing and interLATA services, the existing rules satisfy the requirements of the Act. The 1996 Act does not require GAAP to apply. The Commission should not impose that requirement. Current rules meet the arm's length requirement of the 1996 Act. Compensatory pricing is satisfied for nontariffed services by the requirement for fully distributed costing. Current recordkeeping and record retention requirements of the accounting safeguard rules meet the auditability requirement for arm's length treatment. Additional written notice about exchange services provided by a BOC is not needed because all transactions must be described in a BOC's CAM.

The Commission should not require the value of services between a BOC and its affiliates to be based on a comparison of fully distributed costs with fair market value. ("FDC/FMV comparison"). The Commission properly rejected that standard previously as being more subjective, less auditable and thus, less reliable than FDC. In addition, the FDC/FMV comparison will increase administrative costs even if formal studies are not required. If, however, the Commission adopts the FDC/FMV comparison, it should only apply to transactions between a BOC and affiliates required by the 1996 Act and not to services between the holding company and a BOC or any other affiliate. Moreover, the Commission should limit the FDC/FMV comparison only to services with annual billing over $250,000.

The use of prevailing price as a valuation option should be retained so that it can be used when reasonable. The Commission should rule on the issues raised in the Affiliate Transactions Notice proceeding instead of eliminating a legitimate valuation method.

An affiliate that provides regulated interLATA telecommunications services should be deemed to be nonregulated only for Title II accounting purposes to permit the affiliate transaction rules to apply to its transactions with the BOC. However, there is no reason to require an affiliate that provides both interLATA telecommunications services and nonregulated services to use Part 64 cost allocation rules. The affiliate has no incentive to load costs from one competitive product to another.

The Commission appropriately recognizes that price cap regulation affects the relationship of the accounting safeguards to price cap carriers. First, exogenous treatment should not apply to investment reclassified as a result of a change in regulatory status unless the changed status is the result of an underforecasting of nonregulated usage. Moreover, for price cap carriers, exogenous treatment should only apply to a reallocation of investment included in the initial price cap rates. Investment since that time ("new investment") has not been included in price cap rates, and consequently should not be removed.

Finally, a price cap carrier's election of the no sharing option eliminates any incentive and ability to cross subsidize, and thus eliminates the need for the protections of the accounting safeguards. Forbearing from applying unnecessary Part 64 rules will implement the pro-competitive, deregulatory intent of the 1996 Act.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996	CC Docket No. 96-150

COMMENTS OF PACIFIC TELESIS GROUP

Pacific Telesis Group ("PTG") hereby respectfully submits comments in the above-captioned proceeding.[1]

I. Introduction

In this proceeding the Commission proposes regulations to implement the accounting safeguards provisions of §§260 and 271 through 276 of the 1996 Act.[2] These sections permit the BOCs to provide previously proscribed activities upon a BOC's satisfaction

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[1] Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996, CC Docket No. 96-150, *Notice of Proposed Rulemaking*, FCC 96-309, released July 18, 1996 ("*NPRM*").

[2] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act").

of certain conditions.[3] The Commission intends to establish accounting safeguards to constrain potential cost misallocation and discrimination against competitors. *NPRM*, para. 6. At the same time, the Commission affirms its position that once competition exists for local exchange and exchange access services and LEC rates are not dependent on costs, the need for accounting safeguards may vanish. *NPRM*, para. 8. Moreover, the Commission acknowledges its intent to "minimize the burden" its rules impose on those subject to them. *NPRM,* para. 8. Against this backdrop, the Commission generally concludes that current accounting safeguards with proposed modifications can accomplish the dual goals of protecting ratepayers against improper cost allocations and competitors against unreasonable discrimination. *NPRM*, para. 11. We agree that the accounting safeguards *without any modification* are effective to meet the statutory requirements and accomplish the intent of the 1996 Act. On the other hand, to the extent that price cap regulation has eliminated the effect of costs on rates, the accounting safeguards are largely unnecessary. Consequently, while the accounting safeguards will be effective to accomplish the directives of the 1996 Act, the Commission should forebear from applying them to price cap carriers.

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[3] Concurrent with the release of this *NPRM*, the Commission also proposes rulemaking for nonaccounting safeguards for §§271 and 272 in *Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as amended; and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, CC Docket No. 96-149, *Notice of Proposed Rulemaking*, FCC 96-308, Released July 18, 1996 ("*Non-Accounting Safeguards NPRM*"), and for §§274, 275 and 260 in *Implementation of the Telecommunications Act of 1996: Telemessaging, Electronic Publishing and Alarm Monitoring Services*, CC Docket No. 96-152, *Notice of Proposed Rulemaking*, FCC 96-310, Released July 18, 1996 ("*Telemessaging, Electronic Publishing and Alarm Monitoring Services NPRM*").

A. Existing Part 64 Rules Satisfy The 1996 Act's Accounting Safeguards Requirements

The cost allocation and affiliate transactions rules established in the Commission's Joint Cost[4] and Computer Inquiry III Remand proceedings[5] ("Part 64 rules") were developed to ensure that interstate ratepayers did not subsidize a LEC's nonregulated activities. The Part 64 cost allocation rules ensure that the costs of regulated services are properly identified and segregated from nonregulated service costs so that regulated rates cannot reflect nonregulated costs;[6] the Part 64 affiliate transactions rules ensure that the ratepayers are not disadvantaged by cost shifting between a carrier and its affiliates.[7] The Part 64 rules have effectively accomplished the Commission's goals since they were implemented in 1987. The Commission and the courts have affirmed that the accounting safeguards of Computer Inquiry III

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[4] *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, 2 FCC Rcd 1298 (1987) ("*Joint Cost Order*"), recon., 2 FCC Rcd 6283 (1987) ("*Joint Cost Reconsideration Order*"), further recon., 3 FCC Rcd 6701 (1988) ("*Joint Cost Further Reconsideration Order*"), aff'd *sub. nom. Southwestern Bell Corp. v. FCC* 896 F.2d 1378 (D.C. Cir. 1990).

[5] *Computer III Remand Proceedings; Bell Operating Company Safeguards and Tier I Local Exchange Carrier Safeguards*, 6 FCC Rcd 7571 (1991) ("*BOC Safeguards Order*").

[6] *Joint Cost Order*, para. 33.

[7] *Id.*, para. 290.

("CI III"),[8] and price cap rules are an effective barrier to anticompetitive cross subsidy.[9] The Commission has continued to refine the Part 64 rules through orders related to carriers' cost allocation manuals ("CAM"), the BOC Safeguard Order, the CAM Uniformity Order,[10] and the still pending Affiliate Transactions Notice proceeding,[11] strengthening the effectiveness of both the cost allocation and affiliate transactions safeguards. The result is that the current Part 64 rules provide a well developed, comprehensive system that prevents cross subsidy. There is no reason why these rules would not be equally effective for the new services that a BOC or its affiliate may provide pursuant to the 1996 Act.

Moreover, there are distinct advantages to applying this system to the activities permitted under the 1996 Act. First, the BOCs have sound, well developed, auditable systems and procedures in place. Employees have already been trained in Part 64 compliance. Compliance is more easily achieved as employees' knowledge of applicable rules increases.

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[8] *BOC Safeguards Order*, para. 54. *Southwestern Bell Corp. v. FCC*, 896 F.2d 1378, 1379 (D.C. Cir. 1990) (rules "reasonably designed to prevent systematic abuse of ratepayers.") The AT&T Consent Decree's Manufacturing Restriction: Hearing Before the Senate Subcomm. on Antitrust, Monopolies and Business Rights, 102d Cong., 1st Sess. 544 (1991) statement of James F. Rill, (Assistant Attorney General for Antitrust) current FCC cost allocation rules "alleviate the concern that the [Bell Companies] will engage in anticompetitive cross subsidization of unregulated activities with ratepayer revenues"; *see also* National Telecommunications and Information Admin., U.S. Dept. of Commerce, The NTIA Infrastructure Report: Telecommunications in the Age of Information, 233 (Oct. 1991) (FCC rules are "extensive and effective in controlling cross subsidy.")

[9] As discussed below, under price caps, there is no "reward for shifting costs from unregulated activities into regulated ones, for the higher costs will not produce higher legal ceiling prices." *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993).

[10] *Implementation of Further Cost Allocation Uniformity*, 8 FCC Rcd 4664 (1993) ("*CAM Uniformity Order*").

[11] *Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and their Nonregulated Affiliates*, 8 FCC Rcd 8071 (1993). We did not support the proposal to apply the asset valuation rules to services.

Thus, applying familiar Part 64 rules will serve the Commission's goals well. If, however, a new system of accounting safeguards is required, BOCs will have to develop new systems and practices and retrain employees, requiring substantial investments of time and resources, as well as a transition period -- all without any assurance that a new system will be more effective in accomplishing Congress's goals than the present body of rules.

The Commission is correct that implementation costs would outweigh the benefits of any new approach. Redesigning a BOC's internal systems to accommodate a fundamentally different cost allocation approach would impose on a carrier substantial administrative costs. *NPRM*, para. 13. Part 64 has a solid record of preventing cross subsidy and unreasonable discrimination, and there is no reason not to use these rules. The Commission continues to recognize this. Most recently, the Commission said,

> Our experience with regulating the independent LECs' provision of interstate, domestic, interexchange services and the BOCs' provision of enhanced services suggests that our existing safeguards have worked reasonably well and generally have been effective, in conjunction with our regular audits of the BOCs, in deterring the improper allocation of costs and unlawful discrimination. To be sure, we have found instances where individual BOCs may not have complied with our nonstructural safeguards in providing nonregulated services. Our experience to date, however, has not disclosed a systematic pattern of anticompetitive abuses by independent LECs or the BOCs that would indicate that our safeguards are ineffective.[12]

By adopting the existing well-established Part 64 rules, the Commission will also demonstrate its stated intent to minimize the burden on those subject to the regulations. *NPRM,* para. *8.*

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[12] *Non-Accounting Safeguards NPRM*, para. 146.

Establishing a fundamentally different cost allocation approach would be particularly inefficient because price cap regulation significantly diminishes the need for accounting safeguards. First, one goal of price cap regulation was to stimulate carriers to increase productivity and efficiency.[13] Thus, price cap regulation eliminates any incentive for a carrier to undercharge or overpay affiliates, either of which would reduce a carrier's productivity. In addition, cross subsidy concerns are diminished because carriers have no opportunity to recover costs shifted from nonregulated activities to regulated products and services. The safeguard is especially effective for price cap carriers that have elected the no-sharing option. Pacific Bell and Nevada Bell agreed with the Commission's tentative conclusion in CC Docket No. 94-1 that "the sharing and low-end adjustment mechanisms should be eliminated as part of our new permanent price cap plan for LECs selecting a higher X-Factor."[14] With the indirect link between costs and rates severed by the elimination of sharing, price caps serves as an effective safeguard against cross subsidy. As the Commission declared,

> We view the price cap regulatory regime ... as our primary means of protecting the telephone customers of price cap LECs from unreasonably high rates. Under price caps, a LEC has no guarantee that it will be able to recover increased costs in telephone rates. Its incentive to "shift" from video dialtone to regulated telephone services is thus greatly reduced.[15]

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[13] *See Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8691 (1995) ("*Interim LEC Price Cap Order*"), para. 28.

[14] *Interim LEC Price Cap Order*, para. 184; Comments of Pacific Bell and Nevada Bell, January 11, 1996, p. 9.

[15] *Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58,* 10 FCC Rcd 244 (1994) ("*VDT Reconsideration Order*"), para. 166.

Thus, as discussed more fully below, the Commission's concerns about cross subsidy are virtually eliminated for price cap companies that have elected the no sharing option. To that extent, a wholesale overhaul of the existing accounting safeguards that have proven effective would be largely a waste of limited resources.

B. The Commission Should Implement But Not Enlarge On The Intent Of The 1996 Act

The Commission requests comment on the extent of its jurisdiction over the new activities permitted to the BOCs or an affiliate or, in some cases, whether it has jurisdiction over incumbent LECs. *NPRM*, paras. 43-48, 54, 94, 99-100, 113-116. Similarly, the Commission inquires as to the role states may have in implementing accounting safeguards. *NPRM*, paras. 49-50, 55-56, 100, 116. In the 1996 Act, Congress established specific requirements to be satisfied by the BOCs, and in some cases, other incumbent local exchange carriers in order to protect competition and ratepayers during the transition to a fully competitive local exchange marketplace. Those safeguards are set out in distinct sections of the 1996 Act and apply only to the carefully delimited set of activities identified therein. The Commission must give effect to Congressional intent but not enlarge upon that intent or substitute its judgment for that of Congress.

It is abundantly clear from the language of the 1996 Act that Congress made precise choices among the various possible types of separations and other requirements that would apply to each activity, and unambiguously omitted numerous additional burdens on the BOCs that had been proposed by various industry segments. Indeed, Congress custom-tailored the safeguards it deemed necessary for each type of BOC competitive activity, *e.g.*, telecommunications, information services, manufacturing, telemessaging, alarm services, and electronic publishing. In doing so, it differentiated among those activities with respect to geographic market, corporate structure, degree of separation, permissible interactions between affiliates, and the mechanisms for monitoring and enforcing compliance.

The FCC's role here is not to substitute for Congress's judgment nor to add to what Congress has prescribed. Instead, the Commission's role is to enforce the law and, where necessary, interpret its meaning in the course of enforcement. Yet, notwithstanding the clarity of this legislative mandate, the *NPRM* posits numerous questions concerning the need for, or desirability of, adopting additional or different requirements that are nowhere mentioned in the 1996 Act. Each such question must be answered in the negative. To do otherwise would both exceed the Commission's authority under the 1996 Act and directly conflict with that legislation's deregulatory goals.

Moreover, as the Commission notes in a related docket,[16] Congress has defined roles for both the Commission and the states in implementing the statute. In developing the accounting safeguards, the Commission should adhere to Congress's vision of the dual regulatory scheme.

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[16] *Non-Accounting Safeguards NPRM,* para. 24.

II. Existing Part 64 Cost Allocation Rules Protect Against Cross Subsidization Of Integrated Operations

A. Part 64 Cost Allocation Rules Are Exactly Suited To Integrated Operations

As a nonstructural safeguard, the Part 64 cost allocation rules were meant to prevent cross subsidy in lieu of structural separation. Thus, Part 64 rules are particularly suitable to identify and segregate integrated nonregulated costs. Under Part 64, all costs must be fully allocated between regulated and nonregulated operations to ensure that each bears its directly attributable costs as well as its share of joint costs. This fundamental principle applies to all products and services. Part 64 rules do not vary according to the type of product or service. Consequently, the Part 64 rules can be applied to the new services that BOCs are permitted to provide by the 1996 Act.

B. Existing Part 64 Rules Will Prevent Cross Subsidization of Telemessaging Services

Telemessaging service is currently classified as a nonregulated activity and is subject to Part 64 rules. *NPRM*, para. 30. The 1996 Act does not require telemessaging service to be provided through a separate entity. If telemessaging is provided as an integrated operation, the Part 64 cost allocation rules would safeguard against cross subsidy as required by §260(a)(1).

The Commission tentatively concludes, however, that telemessaging is an information service, and that any interLATA information service would be required to be provided by a separate affiliate pursuant to §272(a)(2)(c). *NPRM*, para. 33. As we explain in our comments in CC Docket No. 96-149,[17] we do not agree with these conclusions. If, however, the Commission adopts these tentative conclusions, Part 64 and Part 32 affiliate transactions rules would safeguard against cross subsidy as required by §260(a)(1).

C. *Incidental InterLATA Services Should Not Be Treated Differently Than Current Rules Require*

The 1996 Act permits a BOC or its affiliate to provide specific incidental interLATA services on an integrated basis.[18] Those services should be treated as regulated or nonregulated based on the criteria found in the Joint Cost Order,[19] and the current Part 64 rules should apply as usual to integrated incidental interLATA services. Existing cost allocation rules will meet the statutory requirements of §271(h). *NPRM,* para. 38.

As a result of the 1996 Act, a BOC may provide regulated interLATA telecommunications services. In order to prevent allocation of these regulated costs to regulated local exchange and exchange access services, the Commission suggests that the interLATA regulated services could be treated either as a separate category of regulated services or as nonregulated activities for Title II accounting purposes. *NPRM,* para. 39. There is no need for special treatment for incidental interLATA services, whether regulated or nonregulated. Incidental interLATA services should be treated as usual according to the current rules. In that

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[17] *Non-Accounting Safeguards NPRM,* Comments of Pacific Telesis Group, August 16, 1996.

[18] 47 U.S.C. §271(g).

[19] *See Joint Cost Order,* paras. 70-79.

case, regulated incidental interLATA service costs will flow through Part 32 and Part 64 as regulated costs; Part 36 will separate the costs into state and interstate; and the interstate costs will be allocated by Part 69 rules to the Interexchange price cap basket. The Commission adopted this treatment years ago to separate regulated incidental interLATA service costs from local exchange and exchange access costs.[20] Moreover, the costs in the interexchange basket cannot affect rates in any other basket.

> Capping a basket of services ... also assures, along with other existing regulatory controls, that cross subsidization of services outside the basket by those inside does not occur. This is so because the carrier cannot go above the cap applicable to the basket to recoup revenues siphoned off to subsidize other services.[21]

The Commission reiterated in a later proceeding: "Subdividing LEC services into baskets substantially curbs a carrier's ... ability to engage in unlawful cost shifting between the broad groups of services."[22] The standard treatment of regulated incidental interLATA costs eliminates any need to treat regulated activities as nonregulated for Title II accounting purposes

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[20] *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786 (1990), para. 214. ("'Corridor' offerings (interstate interLATA), international offering, and any other interexchange offering a carrier may provide will be included in the interexchange basket....")

[21] *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, *Further Notice of Proposed Rulemaking*, 3 FCC Rcd 3195 (1988) ("*Dominant Carriers Policy and Rules Further Notice*"), para. 279; *Second Report and Order*, 5 FCC Rcd (1990) ("*Dominant Carriers Policy and Rules Second Report and Order*").

[22] *Dominant Carriers Policy and Rules Second Report and Order*, para. 200.

or establishing a separate regulated Part 64 category.[23] No further Commission action is needed to avoid cross subsidy.

The Commission invites comment on the accounting treatment for access charges that a BOC must impute if a BOC provides itself exchange access service. *NPRM*, para. 41. The Commission suggests one possible approach: BOCs would record imputed exchange access charges as an expense that would be directly assigned to nonregulated activities with a credit to the regulated exchange access revenue account.

This approach is workable only for structurally separate affiliates or subsidiaries. In that case, the revenues and expenses of the BOC and the affiliate or subsidiary are each stated correctly for regulated reporting purposes, i.e., each entity separately reports the results of its own operations. When the results are consolidated, the intercompany transaction is eliminated.

However, when applied to an entity that is not structurally separated, the Commission's suggestion would cause the BOC to artificially overstate its revenues for regulatory reporting purposes. This would distort financial ratios used for analysis, and may put carriers at risk for additional taxes which are based on gross receipts. In addition, the transaction resulting from the proposed approach would also have to be eliminated for a nonstructurally separated entity, since the booking of an internal transaction as proposed would not conform to generally accepted accounting principles.

An accounting treatment for imputed access charges which meets the Commission's objectives currently exists within the Commission's regulatory framework. The

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[23] *Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services,* CC Dkt. No. 96-21, *Report and Order,* FCC 96-288, released July 1, 1996 ("*BOC Out-of-Region Order*"), paras. 38-40.

accounting requirements for regulated services which are treated as nonregulated for Title II accounting purposes are specified in §32.5280(b) -- Nonregulated Operating Revenue.

> This account shall be debited, and regulated revenue accounts credited at tariffed rates when tariffed services are provided to nonregulated activities....

No special treatment is necessary and none should be adopted. The existing Part 32 rule provides for the appropriate accounting treatment.

The Commission also suggests that BOCs that provide interLATA or intraLATA facilities or services on an integrated basis should provide them for their own use at the same rates as those facilities or services are made available to all carriers. *NPRM*, para. 42. Section 272(e)(3) requires that the BOC must impute an amount for access to its exchange service and exchange access service that is no less than the amount charged to any unaffiliated carrier. The language of the statute is plain and clear, and can be met by the existing Part 64 rules. If interLATA or intraLATA facilities or services are tariffed, the tariffs will apply to all similarly situated customers whether the customer is the BOC itself or an affiliate of the BOC. If different rates are available to nonaffiliated carriers, the rate applicable to the BOC should be the rate which would apply to a similarly situated unaffiliated carrier. No further regulation is required by the Commission.

D. No New Safeguards Need Be Adopted To Accomplish Congress's Goals For Payphone Services

The Commission proposes to apply accounting safeguards identical to those safeguards adopted in CI III to implement §276(b)(1)(C) of the 1996 Act. *NPRM*, para. 58. The

Commission also tentatively concludes that payphone service should be reclassified as a nonregulated activity so that its costs should be separated from the telephone exchange and exchange access operations that would continue to be regulated activities. *NPRM,* para. 59.

By reclassifying payphone service as nonregulated, the Commission can apply existing Part 64 rules, and meet the 1996 Act's mandate for nonstructural accounting safeguards at least equal to those adopted in the CI III proceeding. In that proceeding, the Commission determined that the cost allocation rules and asset transfer rules, together with the price cap rules constituted an effective barrier to anticompetitive cross subsidies in the enhanced services industry.[24] There is no reason why these rules should not be as effective for the payphone industry. The reclassification of payphone service as nonregulated will result in separating those costs from the costs of telephone exchange services and exchange access operations.

The reclassification of payphone service, however, should not be categorized as either a "reallocation" or a transfer from regulated to nonregulated accounts. Instead, this event should be recognized chiefly as the deregulation of payphone CPE. As such, the deregulated asset valuation should be consistent with prior Commission precedent where valuation was set at net book value. Valuation should be limited to only the physical assets dedicated to the provision of payphone service reflected on a BOC's books.[25]

Moreover, the exogenous treatment of payphone costs should not be confused with the requirement of §61.45(d)(1)(v) that requires exogenous treatment of amounts reallocated

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[24] *BOC Safeguards Order*, paras. 54-55.

[25] We advocated this position in CC Docket No. 96-128. *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, *Comments of the RBOC Payphone Coalition*, July 1, 1996, pp. 27-30.

from regulated to nonregulated accounts. As explained more fully below, the exogenous reallocation of investment referenced in §61.45(d)(1)(v) relates to a change resulting from a carrier's underforecast of nonregulated investment use. Any exogenous change for payphone costs will occur as a result of an express directive by the Commission, not as a result of the reclassification of activities or facilities from regulated to nonregulated. The Commission has tentatively concluded that "incumbent LECs must reduce their interstate CCL charges by an amount equal to the interstate allocation of payphone costs currently recovered through those charges."[26]

III. The Current Part 64 and Part 32 Rules Offer Effective Safeguards For Separated Operations

Section 272(a) of the 1996 Act requires BOCS to provide certain interLATA services through separate affiliates. Section 272(c)(2) requires BOCs to account for all affiliate transactions according to Commission designated or approved accounting principles.

A. Current Affiliate Transactions Rules Satisfy The 1996 Act's Safeguards Requirements

In addition to safeguarding against cross subsidy of integrated nonregulated operations by regulated operations, Part 64, along with §32.27, ("affiliate transactions rules") also govern transactions between a BOC and its affiliates.[27] The affiliate transactions rules are intended to protect against cross subsidy from a regulated entity to its nonregulated affiliate.[28]

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26 *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, 11 FCC Rcd 6716 (1996), para. 51.

27 47 C.F.R. §§32.27, 64.902.

28 *See Joint Cost Order*.

Thus, the existing affiliate transactions rules are tailor-made for interactions between a BOC and the affiliates which will provide §272 services. *NPRM*, para. 64. We agree with the Commission that existing rules will satisfy the requirements against cross subsidization of separated operations. *NPRM*, para. 64. Given the effectiveness of the existing affiliate transactions rules, it would be economically inefficient to require a fundamentally different accounting system to safeguard against cross subsidy and discrimination in affiliate transactions. The same disadvantages would apply to replacing affiliate transactions rules with something new as would apply to replacing the existing cost allocation system.

B. Changes To Existing Safeguards Are Not Required For Transactions With Section 272 Affiliates

The Commission inquires as to whether the affiliate transactions rules should be applied only to those entities that engage in activities for which the 1996 Act requires the use of a separate or separated subsidiary ("1996 Act subsidiary") or to incumbent LECs ("ILECs") that engage in the 1996 Act activities which may be, but are not required to be, in a separate subsidiary. *NPRM*, para. 66. The current affiliate transactions rules apply to all transactions between a LEC and its nonregulated affiliates, and should satisfy the statutory requirements for avoiding cross subsidy of a separate subsidiary. The proposed modifications to the affiliate transactions rules are unnecessary, and should not apply to any affiliate transaction whether between a LEC and a separate subsidiary required under the 1996 Act or with any other BOC affiliate. *NPRM*, para. 66.

The Commission invites comment on new requirements to implement accounting requirements for the separate affiliates required by §272 of the 1996 Act ("§272 Affiliates").

1. Manufacturing and interLATA services

a. Accounting Requirements: No further action by the Commission is required to implement §272(b)(2)'s requirement for separate books, records, and accounts for the separate affiliates pursuant to §272(a)(2). *NPRM*, para. 68. The requirements of this section are self-explanatory, and can be implemented without further regulation.

b. GAAP: The Commission invites comment on whether requiring affiliates to keep their books in generally accepted accounting principles ("GAAP") will help ensure the 1996 Act's requirement for arm's length transactions between a BOC and its affiliate. *NPRM*, para. 69. There is no need for the Commission to mandate that affiliates that must maintain books, records and accounts separate from the BOC do so in accordance with GAAP. It is appropriate that parent companies and their subsidiaries be able to produce consolidated statements which conform to GAAP. However, internal records are kept in a variety of formats to serve many purposes -- internal management and control, requirements of taxing authorities, and regulatory provisions, as well as GAAP. The Commission should not set rules which govern a §272 affiliate's accounting, bookkeeping, or record keeping practices. When Congress intended that GAAP apply, it said so. For example, §273(d)(3)(B) requires GAAP for manufacturing activities by standard setting organizations. Congress did not require GAAP for all §272 subsidiaries and the Commission should not require it.

c. Arm's Length Requirement: The Commission invites comment on whether to implement requirements to ensure that transactions between a BOC and a §272 affiliate are conducted on an arm's length basis as required by §272(b)(5). *NPRM*, para. 70.